

Message Text

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ACTION EUR-12

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POUCHED AS INFO TO ALL CONSULATES IN CANADA

E.O. 11652: N/A

TAGS: EFIN, CA

SUBJ: REACTION TO INCREASE IN BANK RATE

REF: A. OTTAWA 938; B. OTTAWA 965

1. INITIAL NEWSPAPER ACCOUNTS OF MAR 8 RISE IN BANK RATE
STRESSED UNEXPECTEDNESS OF BANK OF CANADA ACTION (IN LIGHT OF
CURRENT THREE TO FIVE PERCENT SPREAD BETWEEN U.S. AND
CANADIAN INTEREST RATES), EXPECTED INCREASES IN CHARTERED
BANKS' PRIME RATE, AND POSSIBILITY OF MORTGAGE RATES
REACHING NEW HIGHS. BANK RATE INCREASE TO 9.5 PERCENT SETS
RECORD WITH PREVIOUS HIGH ESTABLISHED IN JULY 1974 AT
9.25 PERCENT. IN JULY 1974 CHARTERED BANK PRIME RATE ROSE
TO 11.5 PERCENT AND CONVENTIONAL MORTGAGE RATE WENT OVER
12 PERCENT LATER IN YEAR.

2. ON MAR 8 THREE CHARTERED BANKS -- ROYAL, BANK OF
MONTREAL AND BANK OF B.C. -- INCREASED THEIR PRIME RATE TO
10.25 PERCENT. TORONTO AND MONTREAL STOCK EXCHANGES
DROPPED ON SAME DAY, AND CANADIAN DOLLAR FOREIGN EXCHANGE
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RATE (VIS-A-VIS U.S. DOLLAR) ROSE SHARPLY. (NOON RATE

REPORTED BY BANK OF CANADA WAS US\$0.9850 EQUALS C\$1.00 AS
OPPOSED TO MARCH 5 NOON RATE OF US\$0.9916 EQUALS C\$1.00.)
RISE IN EXCHANGE RATE WAS PARTICULARLY STRONG SINCE
BANK OF CANADA HAS TRIED IN PAST TO KEEP DAILY CHANGE
IN RATE TO ABOUT \$0.0025.

3. TORONTO STAR OF MARCH 8 QUOTED DOUGLAS PETERS,
CHIEF ECONOMIST FOR TORONTO DOMINION BANK, AS SAYING
BANK OF CANADA MOVE INDICATED CANADA'S HIGH INTEREST
RATES WILL CONTINUE FOR SOME TIME. "DON'T BE CRITICAL
OF THE BANK OF CANADA", PETERS REPORTEDLY SAID, "THEY'VE
BEEN LEFT WITH THE SOLE POLICY OF CONTROLLING INFLATION."
MORE OMINOUS WAS PETERS' PREDICTION OF HIGHER UNEMPLOY-
MENT AS A RESULT OF BANK OF CANADA ACTION.

4. CARL BEIGIE, EXECUTIVE DIRECTOR OF C.D. HOWE
INSTITUTE, REPORTEDLY TOLD TORONTO STAR THAT RISE IN
BANK RATE "SMELLS TO ME LIKE A TAX INCREASE IS COMING
IN THE MAY BUDGET". HE IS QUOTED IN MONTREAL GAZETTE
OF MARCH 9 AS SAYING HIGHER INTEREST RATES ARE RESULT
OF STRUGGLE FOR AVAILABLE CREDIT AMONG CONSUMERS,
BUSINESS AND GOVERNMENTS, AND SINCE OTTAWA APPEARS
UNWILLING OR UNABLE TO CURB SPENDING, SOME CROWDING OUT
IS INEVITABLE, WITH BUSINESS AND CONSUMERS LIKELY TO
FEEL THE PINCH THE MOST.

5. GLOBE AND MAIL EDITORIAL OF MARCH 8 TOOK FEDERAL
GOVERNMENT TO TASK FOR NOT PRACTICING FISCAL RESTRAINT
SIMILAR TO MONETARY RESTRAINT IMPOSED BY BANK OF CANADA.
HOWEVER, EDITORIAL POINTED OUT THAT BANK'S ACTIONS HAVE
RESULTED IN OVERVALUED CANADIAN DOLLAR, "WHICH HAS NO
RELATIONSHIP TO THE STRENGTH OF THE CANADIAN ECONOMY,
WHICH IS A GOOD DEAL LESS STURDY THAN THE U.S. ECONOMY,
AND IT IS UNFAIR TO CERTAIN INDUSTRIES AND REGIONS."

6. COMMENT: BANK OF CANADA MOVE TO EVEN HIGHER
INTEREST RATES WILL PROBABLY RESULT IN SHORT-TERM UPWARD
PRESSURE ON INFLATION RATES WITH HIGHER COSTS FOR BUSINESS
EXPANSION, HOUSING AND CONSUMER DURABLE PURCHASES.
(FIRA OFFICIAL, WHO WILL HAVE HIS HOME MORTGAGE "ROLLED
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OVER" THIS SUMMER -- MOST MORTGAGES IN CANADA ARE RE-
WRITTEN AFTER FIVE YEARS AT PREVAILING INTEREST RATES --
TOLD EMBOFF HE WAS APPALLED AT HAVING HIS 8 PERCENT
MOTGAGE BECOME 12 OR 13 PERCENT THIS SUMMER).

7. ALTHOUGH SOME OBSERVERS DOWNPLAY IMPORTANCE OF OVER-
VALUED CANADIAN DOLLAR ON CANADIAN EXPORTS ON GROUNDS
THAT BULK OF CANADIAN EXPORTS ARE COMMODITIES WHICH ARE

LARGELY UNAFFECTED BY CHANGES IN DOLLAR'S EXCHANGE VALUE, EMBASSY CONSIDERS THIS TO BE OVERLY SIMPLISTIC VIEW OF ECONOMY AND FINDS IT HARD TO SEE HOW OVERVALUED CANADIAN DOLLAR FOR ANY EXTENDED PERIOD OF TIME CAN AVOID HAVING ADVERSE EFFECTS -- POSSIBLY RATHER SERIOUS -- ON CURRENT ACCOUNT BALANCE. (SOME ANALYSTS HAD BEEN PREDICTING DROP IN C\$ FOREIGN EXCHANGE VALUE IN MID-1976 AS FOREIGN BORROWINGS OF PROVINCES AND MUNICIPALITIES LESSENED. NOW, HOWEVER, EXPECTED WIDENING OF SPREAD BETWEEN U.S. AND CANADIAN INTEREST RATES MAY SPUR ADDITIONAL CANADIAN BORROWINGS ABROAD AND ACT AS LURE FOR INCREASED FOREIGN FUNDS INFLOW).

8. SOME ANALYSTS ARE ALREADY EXPRESSING FEARS OF LONG-TERM CONSEQUENCES OF CURRENT HEAVY CANADIAN BORROWING ABROAD BY POINTING TO COSTS OF EVENTUAL REPAYMENT AND EFFECTS OF SUCH COSTS ON CANADA'S BALANCE OF PAYMENTS IN YEARS AHEAD. ITC ASST. DEP. MINISTER JEFF CHAMBERS TOLD EMBOFF ON MARCH 9 THAT LARGEST PERCENTAGE INCREASE IN 1975 CURRENT ACCOUNT DEFICIT CAME FROM SERVICE PAYMENTS, AND THAT FOREIGN BORROWINGS WOULD EXACERBATE SITUATION IN FUTURE. TO OVERCOME THIS DEFICIT, HE SAID, CANADA MUST OBTAIN "EXTREMELY LARGE" MERCHANDISE TRADE SURPLUS, AND, IN HIS OPINION, FUNDAMENTAL CHANGES MAY BE NECESSARY IN CANADIAN TRADE POLICY. (HE DID NOT SPECIFY WHAT THOSE CHANGES WOULD ENTAIL).

9. THUS FAR, MOST PUBLIC CRITICISM HAS NOT CENTERED ON BANK OF CANADA'S DETERMINATION TO PURSUE MONETARY RESTRAINT BUT HAS BEEN DIRECTED AGAINST GOC FOR NOT PRACTICING SIMILAR FISCAL RESTRAINT. "EXCESSIVE" GOVERNMENT SPENDING IS RECURRENT THEME OF FINANCIAL COLUMNISTS AND BUSINESS LEADERS, AND RECENT BANK OF LIMITED OFFICIAL USE

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CANADA ACTION PROVIDED CRITICS WITH YET ANOTHER OPPORTUNITY TO CONTRAST GOC EXPECTED INCREASE OF 16 PERCENT IN FY 76/77 EXPENDITURES WITH BANK'S "TIGHT" MONEY POLICY.

10. EVEN WITHOUT BANK'S MOVE TO HIGHER INTEREST RATES, CONFERENCE BOARD AND OTHER SOURCES HAVE BEEN PREDICTING RISE IN UNEMPLOYMENT RATES IN NEXT SIX MONTHS WITH JOB OPENINGS FAILING TO KEEP PACE WITH GROWTH IN LABOR FORCE. WHAT ADVERSE EFFECTS HIGHER INTEREST RATES WILL HAVE ON BUSINESS EXPANSION AND ULTIMATELY ON UNEMPLOYMENT RATES IS DIFFICULT TO DETERMINE AT THIS TIME. CONFERENCE BOARD IN JANUARY QUARTERLY SURVEY OF CONSUMER CONFIDENCE REPORTED SHARP DROP IN CONSUMER SPENDING PLANS, AND WITH EVEN HIGHER INTEREST CHARGES

FOR HOUSING AND DURABLE PURCHASES AS RESULT OF BANK OF CANADA'S CURRENT ACTION, CONSUMER SPENDING PLANS MAY DECREASE EVEN FURTHER. THUS, ANALYSTS AND GOC OFFICIALS WHO HAVE BEEN PREDICTING REAL GNP GROWTH OF ABOUT 5 PERCENT FOR 1976 MAY HAVE TO REVISE THAT FIGURE DOWNWARD. ENDERS

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